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CURRENCIES AND CREDIT MARKETS

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"There cannot be intrinsically a more insignificant thing, in the economy of society, than money; except in the character of a contrivance of sparing time and labor . . . It only exerts a distinctive and independent influence of its own when it gets out of order."

John Stuart Mill, Principles of Political Economy, 1848
Book III, Chapter 7, p.3.

HIGHLIGHTS

The most difficult times for investors are right after the first market declines. Confusion is at its greatest and the calls of the vested interests are more feverish than ever. The 1930s were littered with investors who jumped in much too early. Investors should hang on to liquidity at all costs.

Considering the enormity of the speculation that went on, particularly in the U.S. bond market, we have no doubt that world financial markets will remain under pressure, experiencing only limited recoveries at best. We think the great financial bubble has only begun its bust.

History says that every financial crash finds all its causes in the speculative excesses that preceded it. The degree of pain in the aftermath is similarly related. On this basis, the unwinding of the global financial bubble can hardly be over.

Was the past financial boom a monstrous bubble or solidly based on healthy fundamentals? The answer leads to a very simple question: Did the boom reflect a general surge in the supply of savings or inflationary monetary policy?. Clearly, as we explain, it was the latter.

But how can there be inflationary monetary policy when money growth remains sluggish? It is possible and is well documented in the history books. A major clue is found in the sudden change in the desire to hold money balances. It signals a major disturbance in the monetary sphere.

It is an undisputed axiom in economics today that inflation and inflation expectations alone influence interest rates. According to this argument, interest rates should fall and good times roll again. This is nonsense. We show that this idea finds absolutely no backing in economic theory.

What will the Fed do next? Is another rate hike in the offing? While another small hike is possible, we think a surprising slowdown in the U.S. economy in the second half of the year will cause them to abort their monetary tightening. That will be disastrous for the U.S. dollar.

As we have always stressed, the dollar's weakness is of a long-running structural and secular nature and is rooted in many years of under-investment resulting in a collapse of capacity and productivity growth. The dollar's recent weakness is already ominous indeed.

The preservation of liquidity remains the all-important objective for investors at this juncture. Short-term bonds in the hard currency markets and cash-equivalent investment remain the recommended havens for conservative investors.

NO JOY AMONG THE RUINS

In the annals of modern financial history, the global bond market calamity of recent months ranks as one of the worst. Losses have been stupendous — mind-boggling is the only word for it — particularly so among the professional punters, brokers and banks who should have understood the risks better than most. Yet, despite continued aftershocks, hope springs eternal. The sophists of the financial community have not been slack at inventing new stories that promise much better times ahead.

How many investors will be taken in by these new inventive, sweet-sounding stories and enticements? Though legions of reckless investors may have been chastened by the recent market earthquakes around the globe, the demeanour of the financial community and the nature of investors suggests that the speculative juices have not yet been entirely extinguished. This remains a dangerous time — a period of confusion, of doubt, of new promises and harmless sounding explanations for recent market losses. If the great financial bubble, as we have come to call it, indeed has begun to unravel, one needs to remain resolute in one's convictions. And that is the main thrust of this letter: to reconvey our convictions and to reemphasize our long-running warning — to stay liquid.

INVESTOR'S DILEMMA

No doubt, the recent bond market rout was global, though it struck different countries by varying degrees. But, that investors in U.S. bonds suffered losses of between 7 and 15 percent, depending on the maturity, in the space of less than three months is hard to believe. Liquidity virtually vanished overnight. For the most liquid and highly developed bond market in the world, this definitely qualifies as a crash.

Europe was caught in the speculative web, too. Not surprisingly, the bonds of the countries with high-yielding currencies - the British pound, Italian lira, Spanish peseta and Portuguese escudo - saw the greatest damage. These bonds had the worst fundamentals yet attracted the most cross-border speculation. Whatever the case, the speculative activities of international bond market players was so pervasive that markets everywhere suffered sharp losses — especially in the emerging markets.

Having been badly burned, investors, fund managers and speculators are agonizing over the question of what to do next. They are torn between two competing messages: on the one side, realizing the stark reality of what has happened in the world's bond markets, they are worried and cautious; and on the other, many soothsayers mock those who doubt that the best half of the stock bull market still lies ahead. Who to believe; what to believe? There are only three alternatives: 1) Cut ones losses and run for the comforting safety of liquidity; 2) Sit out the stock and bond markets' downturn and wait for a rebound to recoup losses; 3) Use the lower prices as a favourable buying opportunity, averaging down one's price or initiating new investments. Apparently, as a matter of interest, U.S. banks have elected this last alternative of late. They have again stampeded into the bond market with a vengeance. In the five weeks to April 6 alone, they bought bonds at an unprecedented rate, making net purchases of $35 billion.
For investors, the correct alternative ultimately, of course, depends on whether the slump in stocks and bonds is a classic "correction" or whether a true, long bear market has only begun.

Our own opinion is clearly on record. In past letters we have detailed and chronicled the emergence of the greatest global financial bubble in history — a bubble that was overripe for something to burst it. We think it has only begun its bust. Considering the enormity of the leveraging and speculation that went on, particularly in the U.S. bond market, we have no doubt that the U.S. bond market will remain under pressure. And if bonds remain under duress, it leaves no chance for the stock market either. Generally, financial markets around the world will be repressed from here on, experiencing only limited recoveries.

VESTED INTERESTS TO THE RESCUE

The financial and investment industry is large and has its vested interests: It likes bull markets better than bear markets. Wall Street and the City of London, to mention two of the main hot-beds of financial influence and sophistry, are doing their best to bait the hook . . . to keep investors' hopes alive. For one, there is much talk of the U.S. economy's newly-gained strength and the promising prospect of a world recovery. Many commentators find it utterly inconceivable that markets may be fairing terribly while the economy is doing very well. However, to think of it, nobody found it strange to see the markets boom while the economies did badly during recent years. So, this is a specious argument at best. Markets can go down even though economies may be improving.

True, compared with the worldwide blow-off in bonds, except for the emerging and other exotic markets, stocks, at least relatively, have generally been surprisingly resilient. Considering that stock markets were generally overvalued — in some cases extremely — and driven by declining interest rates, this is remarkable given that the major prop of low interest rates has been pulled out from under the high prices.

But quick to fill the breach, the bulls quickly muster an enticingly sweet explanation. They trumpet the story of a profit explosion that will emerge from an expected world economic recovery next year. According to their script, further corporate restructuring and strong productivity gains will outweigh the negative impact of declining liquidity and rising interest rates. It is claimed that corrections of this sort, when earnings support takes over from interest rate declines, is a normal mid-cycle occurrence that happens in every bull market. The implication, obviously, is that the second half of the bull market still lies ahead.

That most brokers and banks still promote buying recommendations is hardly a surprise. Not only does it serve their vested interest, it suits the fact that they are really at a complete loss to understand what shattered the markets in the first place. Goldman Sachs speak of an "*oddity*" and a "*perverse*" reaction applying to the markets. C.J. Lawrence called it a "*bizarre over-reaction.*" For them, it remains an "*absolutely sound*" bull market driven by the "*most excellent*" fundamentals.

In this vein, it has become a comforting explanation that the bond crash had its cause in the forced unwinding of fairly complicated bond positions in the mortgage-back securities and other exotic fixed income markets (i.e. emerging market debt). This unwinding is said to have affected the credit markets as a whole because the speculators had hedged their positions in these securities by shorting Treasury bonds. When they faced margin calls, they sold what they could sell, namely Treasuries.

According to these and other stories, it was mainly a limited group of big speculators with excessively large and leverage positions, above all the renowned hedge funds — the modern-day buccaneers of global markets — which aggravated the bond slump. This story implies the hopeful message that after a "cleansing" of these positions has taken place, that markets are bound to stabilize and recover sooner or later. We disagree. The hedge funds are simply being used as the convenient scapegoat. The truth is that the entire financial community — banks, brokers and others — were involved in a massive leveraging of the fixed-income market.

THE INVESTOR'S WORST ENEMY

To be entirely fair, there is a certain inertia, too, that sets in at major turning points. It's a function of

the nature of investors. When in doubt, people normally tend to "wait and see." In any case, most investors dread realizing losses or even forfeiting earlier profits. As a result, they too often wait until mounting losses finally unnerve them and drives them to panic selling at any price.

Most fund managers, as the stewards of other people's money, are even less flexible. The reason is that their clients' losses, though regrettable, are less wrenching for them than the relative performance which rules their reputation and their own profits. Any loss, however big, is acceptable as long as it is in line with the average loss of competing investment funds. Therefore, if most others stay invested, worldly wisdom in the financial community teaches them to do likewise whatever the ill consequences for the client. It's all these influences that add to the confusion in the immediate period following the first phase of market declines. To repeat, it's important to stick to one's conviction during theses times.

TRANQUILLITY IN THE CURRENCY PITS

Strangely, considering the bedlam in the bond markets, the currency markets have appeared as an oasis of calm. True, they had their speculative blow-off in August-September of 1992 when the European Monetary System (EMS) fell apart, triggering devaluations of 20% and more in some of the major currencies — the Italian lira, the Spanish peseta, and the British pound.

Still, the major currencies aren't behaving at all as had generally been expected. The big and most unpleasant surprise for forecasters and speculators is the weakness of the U.S. dollar. It has poured cold water on the rampant speculation that had built up on the strength of this bullish view for the U.S. currency. For the whole world financial community, it had been a foregone conclusion that the U.S. dollar would soar on the strength of its attractive relative economic fundamentals. It was widely believed that a strong recovery resplendent with rising interest rates would cause the dollar to shoot up against the currencies of the recession-prone German and Japanese economies. Yet, as we now know in hindsight, it didn't turn out that way.

Besides the disappointing fundamentals for the dollar (a topic which we will come back to later), its trading action appears ominous, too. Its response to news of a rate cut by the Bundesbank or a rate hike by the Fed is a quick, short-lived rise. Within a few hours, if not minutes, it relapses again, often to lower levels than before. All this suggests that many dollar bulls are capitulating and using any dollar rally as an exit.

THE BLINDNESS OF THE CONSENSUS VIEW

What causes a true bear market? History says that every financial crash finds all its causes in the speculative excesses that preceded it. This, again, begs the crucial question of what really propelled the past financial boom. Was it, as the consensus thinks, excellent "fundamentals" or, as we think, unprecedented speculative excesses?

But how is it possible that we can identify a huge speculative bubble — the biggest one in history, right under everybody's nose — where the conventional wisdom in the markets sees nothing but sound fundamentals? Well, for one, our views don't depend on the wisdom from Goldman Sachs, Merrill Lynch or James Capel or other such kindred spirits, but from the writings and teachings of the leading economists of the past. Using them as a reference point, our views must really be seen to be conventional. It's the rogue views of the financial houses we mentioned above that must be seen as aberrant wisdom.

In our view, frankly speaking, the intellectual level of discussion in economics today is far inferior to that in the past, for comparisons sake, the 1920-30s. One of the obvious reasons that is so, is that debate between academics then had no vested interests in the markets and focused primarily on long-run aspects and implications. Today, the public discussion of economics and finance around the world is dominated by an army of economists who are paid by banks and brokers with strong vested interests in selling financial assets, no matter what the environment and the circumstances.

Another reason for the relative blindness of today's economists is that most of them know next to nothing about economic history and theory. The tendency is to think that with the advent of computers and quantitative modelling, that modern economics has become vastly superior. Who needs history? In fact, why even take the time to think about theory when everything has been reduced to economic robotics? It's this deficiency that makes today's economists so prone to invent new theories of their own that are nothing more than rubbish.

A FIXATION WITH INFLATION

So, to repeat, in the consensus view the long and steep fall in interest rates, firstly in the United States and then in the rest of the world, was fully vindicated by excellent market fundamentals. In their eyes, the two key fundamentals were falling inflation rates and record-low or falling short-term interest rates. Stocks and bonds were seen as being cheap relative to short-term rates. Unfortunately, to their loss, the world financial community readily took this for sophisticated economics. We took it for what it was: a load of crackpot ideas and sales pitches perpetrated by banks and brokers.

It has become an undisputed axiom in economics today that inflation and inflation expectations alone influence interest rates. But it's nonsense to make these the exclusive parameter for interest rates, even over the short-run. This idea finds absolutely no backing in serious economic theory. According to established theory, market interest rates are shaped by credit demand relative to the supply of savings derived from current income. Considering that our governments are destroying capital at an unprecedented scale by their bloated budget deficits, it's absurd to think that interest rates should be at record-lows.

By postulating that interest rates are determined by inflation expectations and nothing else, the economist alchemists of the banks and brokers have succeeded in sweeping the existing problems of gargantuan budget deficits and diminishing savings under the carpet.

Even more absurd is the common practice of vindicating the super-high stock and bond prices as a function of the record-low short-term interest and inflation rates that have prevailed for so long in the United States. As if this were a healthy fundamental. Of course, these abnormally low rates were absolutely crucial in fuelling the financial boom, firstly, by creating an irresistible incentive to apply extensive leverage to the purchase of fixed-income securities; and secondly, by chasing millions of savers out of their safe haven of liquid assets.

Clearly, in this respect, the low rates were tremendously effective. But these dynamics by no means qualify them as a positive "fundamental." To be sure, they were very healthy for the banks and the brokers, but for the economy as a whole they were severely negative because they led to appalling speculative excesses and financial distortions. The price for this will only be evident over the long-run.

BUBBLE DISCERNMENT

A speculative "bubble" consists of inflated asset prices. But how do we know whether or not asset prices are "inflated"? Is there any sure-fire measuring rod? To this question, the economists of old would have unanimously agreed that there is. They would have argued that all one needs to do is check the sources of the money flowing into the credit and investment markets. In the case of identifying an asset inflation or an asset bubble, one would see large flows of money from inflationary sources, as distinct from available savings.

For these economists, the key distinction lay between two separate sources of money: savings and inflation. But then, the term "inflation" was used in the broadest sense and covered all money flows induced by loose monetary policy regardless of their effects on the money supply or the conventional price indexes. Inflation was seen as much more than the price inflation which has become the touchstone of today's economists.

There was only one reputed international economist who explicitly disputed the crucial role of savings in shaping interest rates. He was Keynes. It caused a heated, acrimonious debate with his leading British fellow economists who unanimously opposed him on this point. Apart from him, there was virtual unanimity on the crucial role of savings. For some reason, today, most economists seem to be persuaded by Keynes' view even though he was so roundly discredited on this point in his day.

So the answer to the question of whether the past financial boom was solidly rooted in healthy fundamentals or was a monstrous speculative bubble, really boils down to a very simple question: Did the boom reflect a general surge in the supply of savings or loose monetary policy?

On this question the evidence is clear. There is little excuse to beg ignorance. Everybody knew perfectly well that this long financial boom had absolutely nothing to do with the supply of new savings but rather was directly related to a rampant yield-curve speculation and huge money flows out of existing bank deposits into stock and bond mutual funds.

As well, everyone knew both these torrential flows of money into the credit and investment markets had been sparked by the collapse in U.S. short-term interest rates. And last but not least, it is well-known how these abnormally low rates had come about: They were the direct result of the policies of the Federal Reserve. It pitched its fund rate at 3% and froze it there with unlimited reserve injections.

What is it when a central bank keeps its interest rates at a level that barely matches the inflation rate for a prolonged period? By definition, it qualifies as a loose, extremely loose, monetary policy. As it turned out, the main effect of this monetary looseness was to inflate the demand for securities, rather than the demand for goods and services.

But instead of denouncing this as a misguided monetary policy which recklessly fuels a speculative bubble and runaway asset price inflation, the Wall Street pundits hailed the resulting boom as reflecting most healthy fundamentals. So much for their knowledge of history and economic theory.

THE MONETARY CONUNDRUM

Admittedly, the great monetary paradox in all this is the co-existence of booming financial markets with

the weakest broad money growth in the whole postwar period. How can there be inflation in the asset markets or anywhere else when money growth is so weak?

Originally, this greatly puzzled us. However, what was so utterly strange initially, had two perfect explanations as we found out, reading the literature of some of the old economists.

One explanation is that most of the yield-curve playing with borrowed money by institutions other than banks does not increase the money supply. Thus, there was a massive credit creation without attendant money creation. The second explanation is that institutions and individuals can increase their spending on goods or securities by reducing their existing money balances (as compared to spending out of their current income). Indeed, this has happened on a large scale and also leaves the money stock unchanged. No money leaves the banking system or M2. What happens is that deposits change ownership.

Banks are the only institutions whose borrowing and lending adds to the money supply. Borrowing and lending by any other institution — non-bank institutions — does not alter the money stock, except to the extent that they refinance their credits with bank loans.

A case in point are the brokerage houses. As a group, they are second to the banks in their yield-curve playing activities. With total security loans and investments of $455 billion recently, up from $250 billion at the end of 1990, they had a significant role in fuelling the financial boom. Obviously, the brokers leveraged up their balance sheets considerably in the intervening period. But of their borrowed funds, only $100 billion, up from $36 billion, came from banks, thereby resulting in money growth. Their two main sources of finance — customer credit balances and security repos with corporations and institutions — leave the money supply unchanged.

Another special case are the hundreds of billions of dollars which U.S. individual investors have poured into the securities markets, mostly through mutual funds. As already mentioned, this "flight from cash" — now generally referred to under the high-sounding term of a "portfolio shift" — does not alter the money stock either. Still, it correspondingly increases the effective flow of money, though it cascaded into the financial markets rather than into the real economy.

How should we evaluate these particular flows from a monetary point of view? When you ask today's market analysts, they will tell you that it's something very positive since it raises stock and bond prices. When you look into the works of the older economists, however, one learns that they looked at it as an evil, creating distortions in the financial system and the economy. For them, it was quite a familiar phenomenon which at the time was known as the "cash-balance-approach" or the "Cambridge Equation", symbolized by the letter "K" (meaning desired cash holdings).

Basic to this very wise but completely forgotten approach were two ideas: firstly that major changes in desired "cash balances" signal a serious disturbance in the monetary sphere; and secondly, that widespread attempts to reduce desired cash balances were just as inflationary in their effects as major increases in the money supply. For these economists, the crucial question was the motivation of people lowering or raising their cash balances. This, in turn, led these economists to investigate speculation, interest rates and inflation expectations.

We have gone into these theoretical subtleties in order to elucidate the seeming paradox of a speculative bubble coinciding with a period of record-low money growth. With the help of the old economists, the

puzzle is solved, we think. What ultimately counts is the total stream of money — where it's going to, where it's coming from — whatever its many different sources.

THE ENORMITY OF THE U.S. BUBBLE

We did some calculations to ascertain the actual money streams in the United States and made a shocking discovery. During the three years, 1991-93, U.S. M2 grew by $212 billion and M3 by $156 billion. This is very weak broad money growth. Yet, astoundingly, total non-financial debt grew by $1.66 trillion during this period, more than ten times as fast as M3. And, that figure doesn't even capture the huge money flows resulting from the massive yield-curve playing nor the "flight from cash" into stocks and bonds nor the immense leveraging through derivatives. Altogether that could amount to additional trillions of dollars. That a central bank allowed such insanity to run loose is unbelievable.

By the way, the famous quip of Keynes, "*In the long run we are all dead,*" relates precisely to changes in the public's disposition to hold money balances. Conceding that these habits rarely change, he continued: "*But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.*" (Tract of Monetary Reform, p. 65)

Considering the above figures of total flows into credit and investment markets, one begins to grasp the outrageous looseness of U.S. monetary policy over the past several years. As explained, the obvious key to this booming flow of money around the world was the prolonged implementation and retention of artificially low short-term rates combined with over-generous reserve injections.

THE FED'S NEXT MOVE

Our appraisal of the financial boom was always determined by the recognition that it was turning into a colossal speculative bubble. The safest thing to say is that such leveraging has its limits though it can stretch out a lot longer if a central bank refuses to restrain these activities. Wondering about future prospects, we think that recent events have at least broken the momentum of the speculation, though the speculative juices may not have been entirely extinguished.

The main question that beckons over the near-term is whether or not the Fed will raise its interest rates further over the next two or three months, and by how much. In our opinion, we don't believe that the Fed has the stomach for it. It clearly has shown itself to be a friend of Wall Street ever since late 1987. In fact, we're of the opinion that the original motive of the Fed in raising interest rates was to preserve the bond market from inflation fears and to sustain the buoyancy of the securities market overall. Unfortunately, the manoeuvre blew up in its face . . . the bubble had already inflated past the danger point. Clearly, the Fed doesn't want to be seen holding the smoking gun. With the economy already surprisingly slow during the first quarter, and with more weakness to come over the course of the year, the Fed will likely reassess its tightening moves.

One major cause of economic weakness may well be a sharply widening trade gap which correspondingly cuts GDP growth. Actually, it's a favourite argument of the opponents of Fed tightening that domestic capacity constraints have become obsolete in a world where other countries have ample unused capacities. To that extent, it's believed that a widening trade deficit is a good thing because it relieves domestic inflation pressures.

On the surface, that's true. But it essentially implies that soaring trade and current-account deficits are irrelevant. That's a dangerous assumption. In fact, some market pundits are already entertaining the idea that the bull forces will again return to the markets when weaker-than-expected economic growth causes the Fed to stop tightening, if not to partly reverse itself. In our view, if this happens, it will surely precipitate a dollar crisis.

THE SECULAR TREND OF THE U.S. DOLLAR

Underlying the rosy notion that the trade balance will take care of domestic inflation, is the prevailing, simplistic perception that the prices in the supermarkets are the only gauge that counts for monetary policy. It used to be conventional wisdom in economic circles and the currency markets that inflation has its earliest effects in the trade balance rather than in the domestic price indexes. It was recognized that a rising trade deficit had a delaying effect on domestic inflation pressures. That's why rising trade deficits tended to alarm the currency markets. On this score, it is indisputable that the U.S. has a lot of inflation, only it's found in the trade deficit and the financial markets.

In this respect too, today's economists have succeeded in turning former sagacity upside down by asserting that a rising trade deficit reflects a strong differential in relative economic growth against other countries. The historic truth, on the contrary, is that in the long run, the nations with the highest economic growth have also the strongest trade balances because they usually have high savings and investment rates.

That brings us back to the weakness of the dollar, surprising as it is to the consensus. Here another fashionable and simplistic model is going to shambles. The chief planks of the dollar bull story were comprised of three elements: its cheapness in terms of purchasing power; strong U.S. economic growth; and rising U.S. interest rates relative to falling interest rates in Europe and Japan.

As we have always stressed, the dollar's weakness is structural and of a long-running secular nature. Its vulnerability finds its root in many years of under-investment, particularly in manufacturing, resulting in a collapse of capacity and productivity growth. Even if U.S. producers may have regained price competitiveness, they have progressively fallen back in relative capacity and capital stock growth.

The capacity shortage is acutely highlighted by the fact that U.S. merchandise imports are soaring although real GDP growth in the last three years has fallen far short of the typical cyclical expansion. During the first two months of this year, the U.S. goods trade deficit has hit $25.2 billion, or $150 billion at an annualized rate. Only in 1987 was it higher if only by a bit. This trade deficit would correspond to a current-account deficit of about $120 billion.

The chronic and rising U.S. trade and current-account deficit tells us in the first place that U.S. domestic demand is rising faster than domestic supply. This inflationary gap is filled by surging imports. Since the 1980s, there is a distinct correlation between falling U.S. savings and investment rates and a growing current-account deficit. And, as a matter of fact, this is perfectly in tune with traditional theory.

Current-account deficits have to be financed by capital inflows. Currency strength of a deficit country therefore depends on relative monetary conditions and a foreigner's willingness to invest in dollar assets. This is the key question for the dollar and also applies to the currencies of all deficit countries. Forget about purchasing power parity (PPP) and all the other arguments of the dollar bulls. Focus on the capital account. With a large current account deficit, the U.S. has to attract foreign capital one way or another.

THE IMPACT OF THE DOLLAR ON U.S. FINANCIAL ASSETS

Why did the dollar fail to follow the bullish script? In short, because U.S. monetary policy has been the loosest in the world in recent years and still is.

It was always clear to us that the dollar's most critical phase would begin when U.S. financial assets finally lose their attractive lustre. And that is exactly what is happening currently. Therefore, to support the dollar would require a rather rigorous monetary tightening. But the acute vulnerability of the overinflated securities markets prevents the Fed from pursuing such a policy. The Fed has no choice but to muddle through, posturing itself with gimmicky little rate hikes, though it has absolutely no intent to do anything harsh enough that might disrupt the financial markets and the economy. In any case, a weak dollar is not something the Fed will be embarrassed about. In fact, government policymakers will even hail this as an additional and welcome stimulus for the economy.

We follow a simple rule of thumb: A bear market in U.S. financial assets is bound to drive down the dollar, and conversely, dollar bearishness will essentially affect U.S. financial markets. The well-being of the dollar and the financial markets mutually depend on each other. The key point is that persistent dollar weakness will curb new foreign purchases of U.S. financial assets. That alone would tend to drive up U.S. interest rates. If foreigners were ever to sell some of their huge holdings of dollar assets, it would mean a "hard-landing" both for the financial markets and the dollar.

For most financial market observers, this scenario is simply too unthinkable. But, we think just such a critical juncture will arrive when U.S. economic growth will prove weaker than is presently expected. For foreign investors who are exposed to exchange market risk, the spectre of a renewed U.S. monetary easing would be a nightmare.

Just what are the chances that the above scenario would happen? For us, it's almost a certitude, likely to happen later this year . . . at the latest, early next year. The U.S. economy's spurt in the fourth quarter of last year was not the beginning of a sustainable, strong expansion. Year-over-year, real growth has amounted to only 3%. The true calamity is that growth at this rate is already too much for non-inflationary growth, given that capacity growth is so low.

MORE MISPLACED BELIEFS AND FALSE HOPES

Wall Street never runs out of new bull stories. The latest one is that booming U.S. business investment and high productivity gains portend a prolonged period of sustained growth along with soaring profits. There is one simple reason that immediately discredits this sales pitch as pure hogwash: the low U.S. savings ratio, which even declined last year.

We doubt that there are quick economic miracles. A decade and more of gross underinvestment in the United States will not be corrected within six months. The same applies to Canada, the U.K. and Australia. As for productivity gains, so far in the U.S. recovery, they are on par — certainly no better than during past postwar cyclical upturns — particularly so following nearly five years of stagnation. As well, since the slack in capacity utilization has been progressively absorbed, the easy cyclical part of the productivity and profits gains are now over. So, also, are the windfall profits from falling interest rates and financial speculation.

Europe has its bullish scripts, too. One story argues that a prevailing economic sluggishness ensures still lower inflation and a further monetary easing, thus ensuring bullish financial markets. An auxiliary to this story is particularly bullish for the stock markets. It says that the recession in Europe has bottomed out and that on the strength of an impending recovery, businesses will reap double-digit profit gains, thus justifying even higher stock prices.

Altogether, these yarns lead many international investors to the happy conclusion that the European stock and bond markets should uncouple from Wall Street and London trends. While some European stock markets have been doing surprisingly well, the bond markets remain a great disappointment. Though cautious monetary easing continues, it has lost its Midas touch for the European bond markets.

The financial pundits take this weakness in the bond market as proof that an economic recovery must be finally beginning in Europe. Of course, that's more grist for the mill of the stock market bulls. Our answer is very different. In short, the weakness in the European bond markets has its main cause in the extreme excesses of last year's international bond market speculation which served to drive long-term rates to artificial lows.

We won't argue much with the assumption that the sharp downturn in the European economy is giving way to a modest recovery. That indeed appears to be happening. What we strongly disagree with is the view that this is the beginning of a self-feeding, business-cycle recovery. Now that U.S. economic growth has sped up (in Australia, Canada and the UK as well) there seems to be a ready belief that monetary easing works after all and that the U.S. economy is leading the world recovery. Despite the inimical lessons of the last few years, as soon as a bit of sunshine cracks through the clouds, the financial community reverts back to its old beliefs. An ingrained euphoria is always lurking below the surface.

CONCLUSIONS

To really understand the gravity of the present threat to financial markets, one has to have a realistic appreciation of the enormity of the accumulated speculative excesses. As we have pointed out, the excesses, whether in the stock, bond or currency markets, are truly outrageous. Taken together, it's the greatest financial bubble in modern history.

Last year's steep decline in long-term interest rates was driven by leveraged speculation, not low inflation nor anything else. To what extent have all those speculative positions been liquidated to date? Very little, we think. Why? Because as the recent trading action betrays, markets have become totally illiquid for the large transactions required to liquidate these weak holdings. As such, the big yield-curve speculators are locked into their positions, unable to sell, and face the prospect of growing losses. Alone the lack of new buying is enough to cause interest rates to rise further.

But hope springs eternal. Most observers — especially in the Anglo countries — are confident that the central banks will ride to the rescue, forestalling any threat of a financial meltdown. They then conclude that one should expect reckless, massively inflationary monetary policies. Yes, some of the banks will see no other alternative. But whatever the size of their efforts, it will be like spitting into a hurricane. The sums involved in this global financial bubble are just too monstrous for central banks to handle.

There is only one way to prevent a financial bubble from bursting: to avoid creating one in the first place. But for that, it's much too late. To recall, it was crashing bond prices that caused the U.S. banking crisis

of 1929-33. The parallels to today couldn't be more ominous.

All markets are at risk, even those considered the most liquid and stable. That's because in a liquidity panic, overleveraged speculators will indiscriminately dump anything and everything that can be sold. For the time being, most still hope that a counter rally will still allow them an opportunity to bail out. What that means is that the big scramble for liquidity hasn't even started yet. It will be awful when it does. A crash will ensue putting into motion Fisher's infamous debt deflation spiral and triggering a liquidity trap. Everybody's individual effort to raise liquidity will only act to undermine it in aggregate.

A liquidity crunch and the associate crashes in the financial markets will heavily impact currencies. Already, the weakness in the U.S. bond market is undermining the dollar and vice versa. It's all parcel of the day of reckoning for the countries with chronic, large current-account deficits. There's little that these countries can do to avoid a free-fall in their currencies.

That's expressly why we have always had a strong preference for the currencies whose strength is derived not from foreign borrowing but from high domestic savings and a strong trade balance. In Europe, the countries of Germany, Switzerland, Austria and Netherlands all qualify in this regard. But even here, we would limit our recommendation to cash or bonds of three years in maturities or less.

And what about gold? Will it prove to be a bastion of value within the bedlam of bursting asset bubbles and currency chaos? Will the expected inflationary policies of the central banks boost its value? In the case of asset bubble busts and the attendant deflationary liquidity crunch, it's not likely that gold will rise. A dollar crisis, on the other hand, would be a positive influence. However, only time will tell. Our preference is liquidity . . . hard cash-equivalents, pure and simple. That's the only sure way to be prepared for the big bargains that will be available for the picking when it all finally unfolds.

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